

No. 7900

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In the United States Circuit Court of  
Appeals for the Ninth Circuit

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CARSON ESTATE COMPANY, RESPONDENT

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ON PETITION FOR REVIEW OF DECISION OF THE UNITED  
STATES BOARD OF TAX APPEALS

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BRIEF FOR THE PETITIONER

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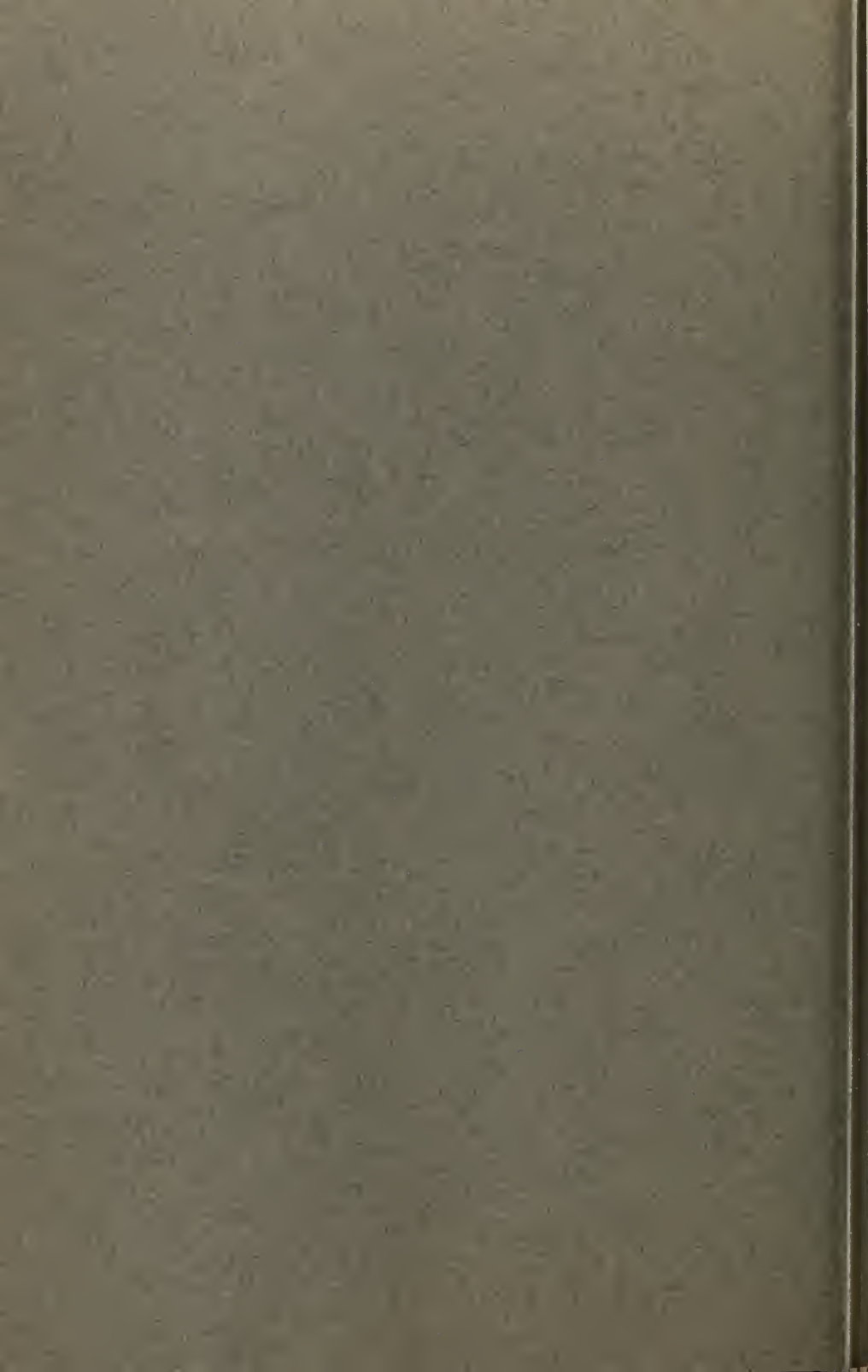
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FILED

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U. S. DEPT. OF JUSTICE



# INDEX

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	Page
Opinion below .....	1
Jurisdiction .....	1
Question presented .....	2
Statutes and regulations involved .....	2
Statement .....	4
Summary of argument .....	6
Argument .....	8
Conclusion .....	15

## CITATIONS

### Cases:

<i>Cornell v. Coyne</i> , 192 U. S. 418 .....	14
<i>First Nat. Bank in Wichita v. Commissioner</i> , 57 F. (2d) 7 ..	12
<i>Heiner v. Colonial Trust Co.</i> , 275 U. S. 232 .....	14
<i>Heryford v. Davis</i> , 102 U. S. 235 .....	9
<i>Pacific Co. v. Johnson</i> , 285 U. S. 480 .....	14
<i>Pollock v. Farmers' Loan &amp; Trust Co.</i> , 157 U. S. 429 .....	14
<i>Western Union Tel. Co. v. Brown</i> , 253 U. S. 101 .....	11
<i>Willcuts v. Bunn</i> , 282 U. S. 216 .....	14

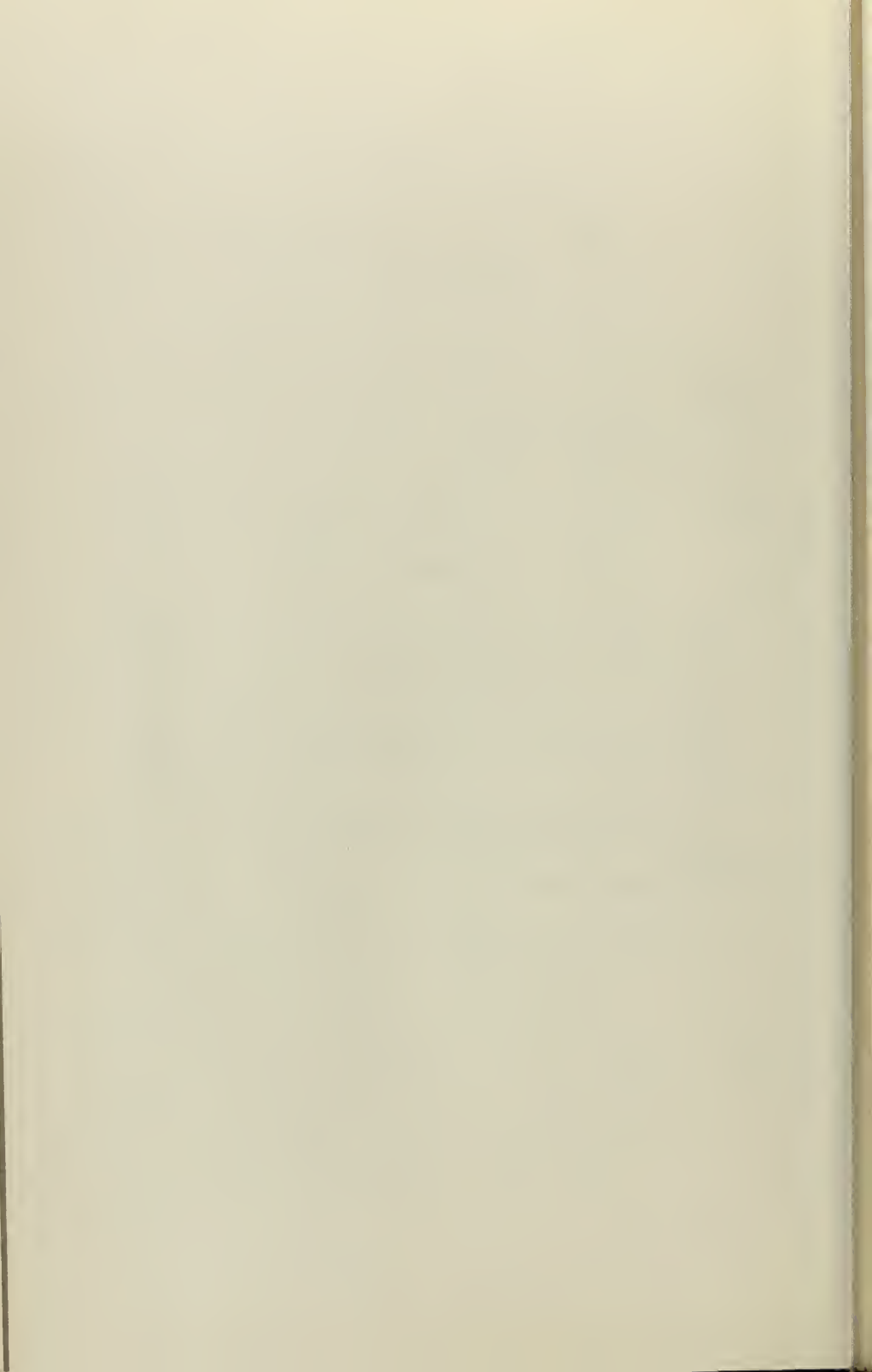
### Statutes:

Revenue Act of 1926, c. 27, 44 Stat. 9, Sec. 213 .....	2
Revenue Act of 1928, c. 852, 45 Stat. 751, Sec. 22 .....	2

### Miscellaneous:

Treasury Regulations 69:	
Art. 74 .....	3
Art. 1541 .....	3
Treasury Regulations 74, Art. 621 .....	14

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**OPINION BELOW**

The only previous opinion in this case is that of the Board of Tax Appeals (R. 23-35), which is reported in 31 B. T. A. 607.

**JURISDICTION**

This appeal involves income taxes for the years 1926, 1927, and 1928 in the amounts of \$1,299.24, \$1,394.21, and \$1,815.31, respectively, and is taken from a decision of the Board of Tax Appeals entered January 9, 1935 (R. 36). The case is brought to this Court by petition for review filed March 25,

1935 (R. 5), pursuant to the provisions of Sections 1001-1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, as amended by Section 1101 of the Revenue Act of 1932, c. 209, 47 Stat. 169.

**QUESTION PRESENTED**

A private corporation deposited tax-free municipal obligations with a trustee and issued certificates of ownership which bore interest at a lesser rate than the bonds so deposited. Is the interest received by the holders of such certificates exempt from tax as an obligation of a State, Territory, or political subdivision thereof?

**STATUTES AND REGULATIONS INVOLVED**

The Revenue Act of 1926, c. 27, 44 Stat. 9, provides in part as follows:

SEC. 213 (b) The term "gross income" does not include the following items, which shall be exempt from taxation under this title:

\* \* \* \* \*

(4) Interest upon (A) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia;

\* \* \*

Section 22 (b) (4) of the Revenue Act of 1928, c. 852, 45 Stat. 751, reads the same as Section 213 (b) (4) of the Revenue Act of 1926.

Treasury Regulations 69, promulgated under the Revenue Act of 1926, provide in part as follows:

ART. 74. *Interest upon State obligations.*—Interest upon the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia is exempt from the income tax. Obligations issued by or on behalf of the State or Territory or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of a State or Territory or a political subdivision thereof. The term “political subdivision” denotes any division of the State or Territory made by the proper authorities thereof acting within their constitutional powers. Political subdivisions of a State or Territory, within the meaning of the exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State or Territory. The purchase by a State of property subject to a mortgage executed to secure an issue of bonds does not render the bonds obligations of the State, and the interest upon them does not become exempt from taxation whether or not the State assumes the payment of the bonds.

ART. 1541. *Dividends.*—Dividends for the purpose of Title II comprise any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumu-

lated since February 28, 1913. Although interest on State bonds and certain other obligations is not taxable when received by a corporation, upon amalgamation with the other funds of the corporation such income loses its identity and when distributed to shareholders in dividends is taxable to the same extent as other dividends.

#### STATEMENT

The facts may be summarized as follows (R. 38-64):

The respondent, during the years 1926, 1927, and 1928, was the owner of certain ownership certificates issued by the Municipal Bond Company, a private corporation (hereafter referred to as the corporation), and as such owner it received during the said years interest upon such certificates as follows (R. 38-39):

1926.....	\$9, 624. 01
1927.....	10, 327. 50
1928.....	12, 127. 51

The ownership certificate issued by the corporation provides that the corporation "does hereby sell and transfer to the purchaser of this certificate all of its rights, title, and interest in Municipal Improvement Bonds issued under the special assessment laws of the State of California", of a specified unpaid face value; that the corporation certifies that such bonds and other like bonds are deposited with a named trustee to hold the same under a trust agreement made a part of the certificate as



though incorporated therein; that the bearer or registered holder of the certificate "is entitled to participate in the proceeds and avails of such bonds, so deposited, to the extent of the principal sum of ----- Dollars, payable from such proceeds and avails on the ---- day of ----- 19----, with interest on said sum from the date hereof at the rate of -- Per Cent (--%) per annum, payable semiannually on the first days of ----- and ----- in each year upon surrender of the coupons hereto attached, as they severally mature"; that the owner of the certificate "is entitled at any time upon demand and surrender of this certificate, together with its unmatured coupons, to said trustee, to receive bonds of unpaid face value equal to the principal sum herein mentioned, the accrued interest to be adjusted as of date of delivery on both this certificate and the bonds so delivered" (R. 60-61).

It also provides that the certificate owner "releases and waives" all interest or other sums collected by the trustee upon such bonds, in excess of the principal sum and interest at the rate specified in the certificate. The corporation has deposited with the trustee, unpaid face value bonds equal to 110% of the principal sum stated in the certificate, "for the purpose of better securing the distribution of the proceeds and avails of such bonds"; that the corporation covenants "that the principal and interest to become due upon said bonds,

when and as the same mature, will be paid. Such covenant to continue as long as such bonds remain on deposit with said Trustee." The certificate is signed by the president or vice-president of the corporation and attested by its secretary (R. 61-62).

The form of the coupon attached to the certificate provides that the certificate owner "is entitled to receive ----- Dollars from the avails of Bonds on deposit with said Bank in Trust No. ----, according to the terms of such Trust, and the Under-signed [the corporation] covenants that the avails from such Bonds will be paid." Such coupon is signed by the secretary of the corporation (R. 63).

The trust agreement (R. 40-59) sets forth in detail the terms and conditions of the trust, the duties and obligations of the trustee and the corporation, and the rights of the parties, but in the interest of brevity its provisions will not be set forth here.

The ownership certificates owned by the respondent bore interest at the rate of 6%, while the municipal improvement bonds which were deposited with the trustee all bore interest at the rate of 7% (R. 39).

#### SUMMARY OF ARGUMENT

The certificates recite an absolute sale of the bonds, but qualify this by making the trust instrument a part of the certificates to the same extent as though incorporated therein. The effect of the transaction must be determined by an analysis of

the provisions of the certificates and the trust agreement, read together as a whole, regardless of the name by which the transaction may be labeled by the parties.

The provisions of the trust agreement are inconsistent with the theory that the certificate holder is the owner of any of the bonds deposited with the trustee. Subject to the obligation to maintain bonds sufficient to comply with the trust agreement, the corporation has every right of ownership. It has even greater property rights than an ordinary pledgor. It seems clear that the obligation of the certificate is the obligation of the corporation, and that all the certificate holder acquires is a lien securing to him the payment of the principal sum covered by the certificate and interest. The right to exchange the certificate for bonds is merely an option, and until exercised does not confer ownership. The transaction represents nothing more than a loan on the part of the certificate holder and a promise by the corporation to repay such loan upon its maturity.

The situation presented here is analogous to the case of where tax-exempt interest is received by a corporation and later distributed to its stockholders as a dividend. In such a case there is no question but that the dividend is taxable.

Finally, Section 213 (b) (4) grants an exemption from taxation and it therefore should be strictly construed.

## ARGUMENT

Section 213 (b) (4) of the Revenue Act of 1926 and the corresponding section of the Revenue Act of 1928 provide that there shall be exempt from tax interest upon the obligation of a State, Territory, or any political subdivision thereof.

The respondent claims that the interest which it received from the ownership certificates issued by the Municipal Bond Company represents in effect, interest upon the obligation of a political subdivision of a State, and therefore is exempt from tax. It is our position that the interest received by the respondent does not come within the exemption provided by the statutes for the reason that it constituted interest upon the obligations of a private corporation.

A proper solution of the question requires a construction of the trust instrument and the ownership certificates issued thereunder. The certificates recite an absolute sale but qualify this by making the trust instrument a part of the certificates to the same extent as though incorporated therein. The provisions of the trust agreement which is thus made a part of the certificates are inconsistent with the theory that the bonds are sold and the title conveyed to the certificate holders. The ultimate purpose and effect of the transaction must be determined from an analysis of the provisions of the certificates and the trust instrument read as a whole, regardless of the name by which the trans-

action may be labelled by the parties. *Heryford v. Davis*, 102 U. S. 235.

Article II of the trust agreement (R. 44-45) provides that the corporation may substitute a larger amount of bonds bearing a lower rate of interest on condition that the interest on the bonds so substituted shall equal the aggregate interest mentioned in the certificates. Article III, Section 1 (R. 15), provides that the corporation may withdraw any or all of the bonds so deposited with the trustee upon delivery to the trustee of an equal amount of bonds of the same character. Section 3 (R. 45-46) provides that whenever the trustee receives in cash the principal or any installment of the principal from any bond on deposit, the corporation shall immediately deposit with the trustee bonds equal to the amount of such cash, whereupon the corporation shall be entitled to receive such cash from the trustee. Thus, subject to the obligation to maintain bonds sufficient to comply with the trust instrument, the corporation has every right of ownership. It has even greater property rights than an ordinary pledgor.

Article IV (R. 47-48) provides that the corporation is the agent of the trustee for the purpose of collecting the interest coupons; that the corporation agrees to purchase from the trustees on the first day of April and October of each year all interest coupons which have not theretofore been collected; that the trustee shall sell to the corporation all ma-

turing coupons of principal, and such coupons shall be paid for by the delivery by the corporation to the trustee of other bonds of a face value equal to the matured coupons of principal. From the above it seems clear that it was in fact the intention of the parties that no title to the bonds, legal or equitable, should vest in the certificate holder by virtue of the issuance of the certificate. It is true the certificate provides that the holder is entitled at any time, upon surrender of the certificate, to receive bonds of a face value equal to the principal of the certificate. But it will be observed that the holder is not entitled to any particular type or issue of bonds, but only such bonds as may be selected by the trustee. Article VII (R. 51-52) provides that "the Trustee shall select from the bonds on deposit with said Trustee, such bonds as *it may deem expedient*, either as to *maturity* or as to *security*, of the unpaid face value equal in amount, as near as possible, to the par value of said certificates so *surrendered*." (Italics supplied.) Such a provision is inconsistent with the idea that the certificate holder is the owner of any of the bonds.

Furthermore, the corporation is entitled to all interest collected by the trustee in excess of the amount required to pay the certificate holders. The agreement recites that the excess interest is to compensate the corporation for the excess 10% of bonds which are deposited with the trustee, but in this connection it will be observed that the certificate

holders receive interest at the rate of 6% while the municipal bonds deposited with the trustee bear interest at the rate of 7%. Also, the corporation is entitled to any bonus or premium that may be received upon the maturity of any of the bonds. Obviously, if the bonds held by the trustees were owned by the certificate holders they would be entitled to all the interest received from such bonds, less, of course, the expenses of the trustee. Also, the corporation would not be entitled to any profit upon their redemption.

Taking the trust agreement and the certificates together, and reading them as a whole, it seems clear that the certificate holder merely acquires a lien securing to him the payment of the principal sum covered by the certificate and interest, together with the right at his election to exchange his certificate for bonds to be selected by the trustee. This latter right is merely an option, and until exercised, does not confer ownership. *Western Union Tel. Co. v. Brown*, 253 U. S. 101.

The obligation of the certificate is the obligation of the corporation. This is borne out by the fact that the certificate is signed in the name of the corporation and attested by its secretary, and the further fact, as mentioned above, that the corporation may substitute other bonds for those on deposit and is entitled to any increase in value. If the certificate is retained by the holder and not surrendered in exchange for bonds, the full amount of

the obligation, both principal and interest, will be retired upon maturity by funds produced by the corporation. Such is the obligation of the corporation regardless of any increase or decrease in the value of the bonds and regardless of the amount of any proceeds, principal or interest, derived therefrom. The certificate holder is entitled to the payment in full of the principal sum represented thereby with interest and nothing more. The certificate, when considered in connection with the terms of the trust agreement, represents nothing more than a loan on the part of the certificate holder and a promise by the corporation to repay such loan upon its maturity. This was the intention of the parties, and this was the legal effect of their transaction.

The situation presented in the instant case is no different, in substance, than if the corporation had secured a loan from a bank and deposited, as security for such loan, tax-free municipal bonds. We think in such a case no one would seriously argue that the interest paid by the corporation on the loan was tax-free in the hands of the bank.

A case quite similar to the instant one is *First Nat. Bank in Wichita v. Commissioner*, 57 F. (2d) 7 (C. C. A. 10th). There, as here, the agreement recited a sale, but the court held that the interest received was taxable, saying (p. 9):

It is contended that the written contract made by the parties when the bonds were de-



livered passed legal title to the bonds in the bank, and by force thereof interest on them was the bank's property. There is no doubt that the form of contract might have been carried out in that way, but the blanks in the contract submitted to the comptroller left an opportunity to the bank of which it availed itself, and the practice as carried on by the parties clearly shows that it was never intended that the bank should be entitled to the interest accruing on the bonds. Conceding that under the contract the legal title to the bonds was in the bank, the uniform conduct and practice of the parties was a joint admission that the interest coupons and their proceeds when collected did not belong to the bank, but were the property of Brown-Crummer Company. They were collected by Brown-Crummer Company and applied to its use and benefit.

Attention is invited to the fact that there is nothing in the trust instrument or the certificate to show that the certificate holder knew the kind, amount, interest rate, maturity, name of obligor, or any other pertinent fact relating to the bonds deposited with the trustee. All that is shown is that bonds issued under the special assessment laws of the State of California have been deposited with the trustee and that the corporation guarantees the payment of the principal and interest of such bonds.

The reason for the enactment of Section 213 (b) (4) of the Revenue Act of 1926 and the corre-

sponding provisions of the Revenue Act of 1928 is well known. For a tax upon the interest of an obligation of a State, Territory, or political subdivision thereof would be a tax upon a State's borrowing power, and therefore unconstitutional. *Pollock v. Farmers' Loan & Trust Co.*, 157 U. S. 429; *Willcuts v. Bunn*, 282 U. S. 216. But we are not confronted with that constitutional prohibition because the bonds here involved had been issued and sold by a political subdivision of the State prior to the time they were deposited with the trustee. At that time the State had received its money and was no longer concerned with the ownership of the bonds. While the interest here involved may have been paid out of funds received as interest upon the obligations of a State or one of its political subdivisions, it lost its identity when collected by the corporation and represents taxable interest in the hands of the certificate holders.

The situation presented here is not materially different than those cases where tax-exempt interest is received by a corporation and later distributed to its stockholders as a dividend. In such a case there is no question but that the dividend is taxable. Article 1541 of Regulations 69 and Article 621 of Regulations 74.

Finally, it is urged that since Section 213 (b) (4) grants an exemption from taxation, the exemption should be strictly construed. *Pacific Co. v. Johnson*, 285 U. S. 480; *Heiner v. Colonial Trust Co.*, 275 U. S. 232; *Cornell v. Coyne*, 192 U. S. 418.

## CONCLUSION

It follows that the decision of the Board of Tax Appeals is wrong, is not in accordance with law, and should be reversed.

Respectfully submitted.

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DECEMBER 1935.

